Outlook on

EUROPE

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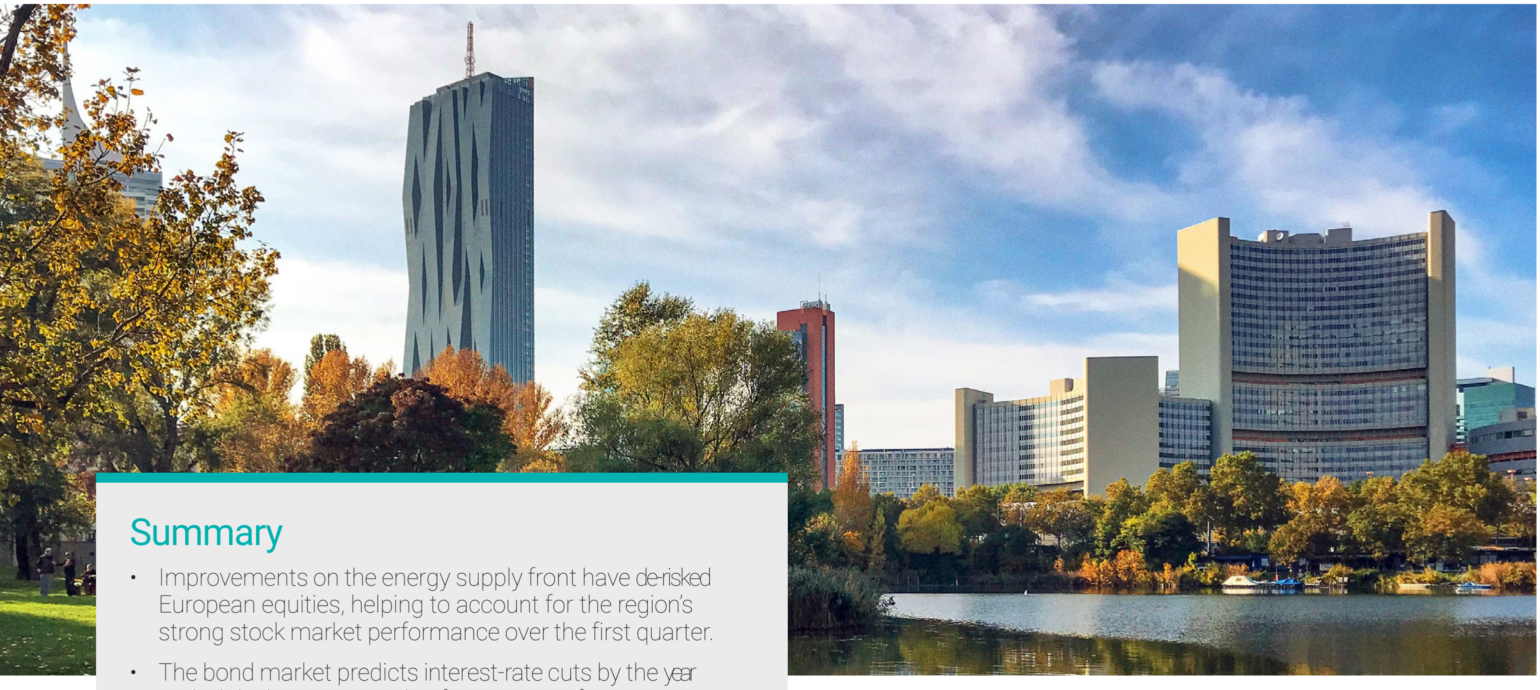
Europe

MAY 2023



Summary

- Improvements on the energy supply front have de-risked European equities, helping to account for the region's strong stock market performance over the first quarter.
- The bond market predicts interest-rate cuts by the year end while the equity market foresees a soft economic landing. We believe both views are somewhat extreme, although we continue to remain cautious on growth.
- European equities remain modestly valued, especially versus US peers. Coupled with some recent economic good news (falling input prices, better consumer sentiment, and China's reopening), this tempers our caution over the growth-dampening effects of higher rates.
- While European bond yields look attractive, we believe fixed income investors should tread carefully given elevated levels of uncertainty.
- We currently favour investment grade over high-yield bonds, although the Nordic high-yield market offers interesting opportunities.

European Equity

The economic mood music across Europe improved incrementally over the first quarter while the region's stock markets were quick out of the gate: the 8.9% rise in the MSCI Europe Index (in euro terms) meant Europe outpaced other major markets. This solid showing was achieved despite the US regional banking crisis rippling out to European shores, driving beleaguered Credit Suisse into the arms of Swiss rival UBS and denting bank share prices.

In a sense, European markets were buoyed by what did not happen rather than what did. Entering 2023, fears over a natural gas supply crisis wreaking economic havoc still loomed large, even after highly effective efforts to accumulate reserves to counter the loss of supply from Russian gas fields. Thanks to a combination of benign winter weather and laudable efforts by Europe's industrial sector to adopt more energy-efficient practices and find alternative energy sources, the crisis never came to pass. This served to de-risk European equities and revised growth expectations upwards.

As an aside, Europe's success in staving off a potential economic disaster reflects well on the region. It is arguably the latest demonstration of the ability of its businesses, governments, and institutions to rise to the challenge in recent years when faced with serious threats, whether from Brexit, COVID-19, or now the Russia-Ukraine war and its game-changing consequences for global energy supplies.

Two-Faced Markets

In the previous quarter, we shared the view that the revival in European equity markets looked overdone, with expectations running ahead of reality and with the full impact of substantial successive interest-rate hikes yet to be felt.

Our caution still stands today, and we note the conflicting signals being emitted by equity and bond markets. On the one hand, the bond market is anticipating European interest-rate cuts by the end of 2023. This implies a serious and rapid deterioration in economic conditions, given the European Central Bank (ECB) remains in rate-raising mode. Barring a serious shock, such as an escalation in the conflict in Ukraine, we think it is highly implausible that the ECB will go from raising rates by 0.50% in March, with annual euro zone consumer price inflation still running well above the central bank's 2% target at 6.9%, to cutting them by the end of the year. On the other hand, we do not subscribe to the equity market view that there is no significant economic slowdown on the immediate horizon but instead more of a soft landing. For us, both views are somewhat extreme and misplaced. We expect the reality will lie somewhere between these two distinctly different scenarios, albeit we continue to lean towards circumspection.

Three Reasons for Cheer

Despite being more glass half-empty than half-full at present, we see three noteworthy positive economic developments that are supportive of European equity markets.

First, input prices are clearly in decline across a range of sectors. This will help further ease inflationary pressures beyond the baked-in drop in power prices as gas price hedges roll off in the summer. Furthermore, as part of the decoupling in economic variables between Europe and the US, wage inflation remains far more subdued on this side of the Atlantic. This reflects a far looser labour market: the US unemployment rate stands at 3.6% versus the euro zone's 6.6%.

Second, despite European consumer sentiment having recovered significantly from very depressed levels last autumn (Exhibit 1), there remains considerable scope for further improvements over the summer. At this point, the recent winter's worries over energy prices will likely no longer be uppermost in consumers' thinking while next winter's heating bills will still be a somewhat distant prospect.

Third, economic momentum in China and the wider Asia region should accelerate as the post-zero-COVID-policy reopening of the Chinese economy begins to gain traction. This may well mitigate growth concerns surrounding the US and Europe. Since European companies are highly exposed to the rest of the world (and increasingly to Asia), this should materially benefit the region's stock markets.

SVB: A First Rate Victim

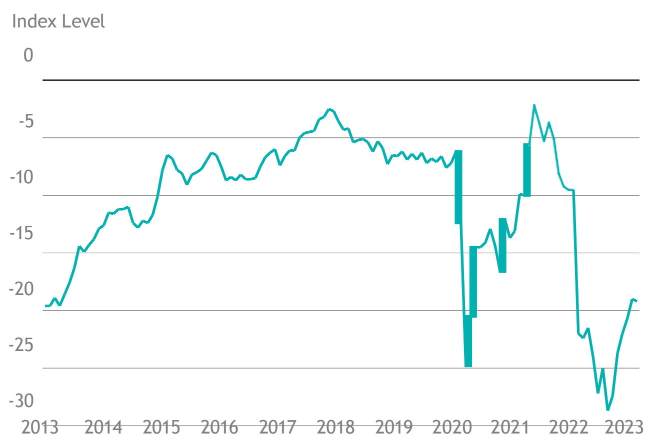
Turning to the banking crisis that erupted in early March in California with the collapse of Silicon Valley Bank (SVB), as we said in our last outlook, "higher interest rates have a nasty habit of delivering unintended consequences and triggering financial accidents". SVB is the first major victim of far tighter monetary conditions, and its demise has probably hastened the arrival of peak rates. However, we would argue that Europe's stricter regulatory framework, borne out of the global financial crisis, means that the balance sheet mismatch between assets and liabilities that tripped up SVB could not happen to a European bank. European banking regulations are much tougher than those faced by regional US banks.

By contrast, Credit Suisse's difficulties came to a dramatic head because of a lack of confidence after repeated scandals and corporate management stumbles rather than fatal (and rather straightforward) balance sheet mismanagement. The panic sweeping the global banking sector after the US regional bank crisis broke was enough to force the lender into a hastily arranged one-sided union with UBS, seemingly under heavy direction from the Swiss authorities, after huge depositor outflows.

From our portfolio perspective, we are now mildly overweight banks. We had reduced our overweight position at the start of the year and trimmed further as the SVB situation unfolded. Overall, though, we believe many European banks look well capitalised (Exhibit 2) while a number continue to buy back stock.

Exhibit 1

Euro Zone Consumer Confidence—Recovery from a Low Base

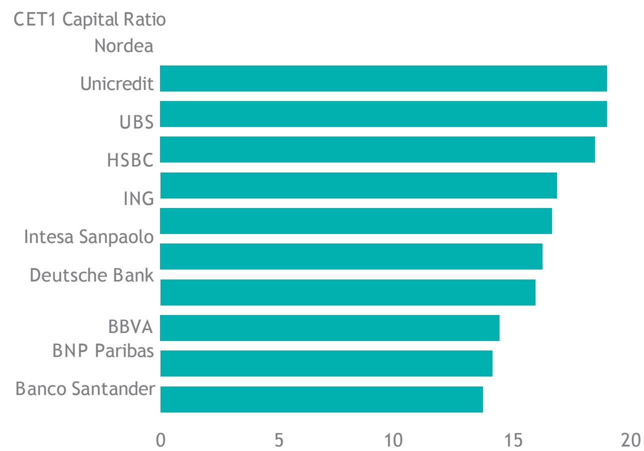


As at 31 March 2023

Source: FactSet

Exhibit 2

European Banks Are Well Capitalised—Tier 1 Capital Ratios



As at 29 March 2023

Source: FactSet

Europe's Climate Plan

Last quarter brought a welcome development in the form of the European Commission's Green Deal Industrial Plan. The plan seeks "to enhance the competitiveness of Europe's net-zero industry and support the fast transition to climate neutrality", aiming to simplify the sustainable economy's regulatory framework and speed up investment in clean technology production in Europe. For example, there are proposals to quicken the approval process for renewable energy projects and to source a certain percentage of equipment, such as heat pumps or batteries, locally. Europe's plan, if executed in a timely way, should help the region compete for investment in sustainable initiatives.

Modest Valuations Offset Our Caution on Growth

In closing, as noted above, we continue to sense some complacency in the equity markets. Our central expectation remains one that sees a bumpy economic landing ahead for the European economy, as the aggressive monetary tightening of the past year begins to bite fully. However, we also observe that European equities remain well underpinned by valuations. With the MSCI Europe Index trading on a historically low 12.7 times forward-earnings multiple, plenty of value remains in European stocks, especially relative to US stocks, as demonstrated through a sector comparison with the S&P 500 Index (Exhibit 3).

Looking at individual sectors, the region's oil companies are currently returning up to c. 14% of their market capitalisations to shareholders via a combination of dividends and buybacks, while its banks are also undertaking major share buybacks. More broadly, falling input prices should ease the pressure on profits across many sectors. And even with potentially tougher economic conditions ahead, we think there are industries, such as car parts and paints, where input prices have already risen sharply, and which should remain resilient given robust demand.

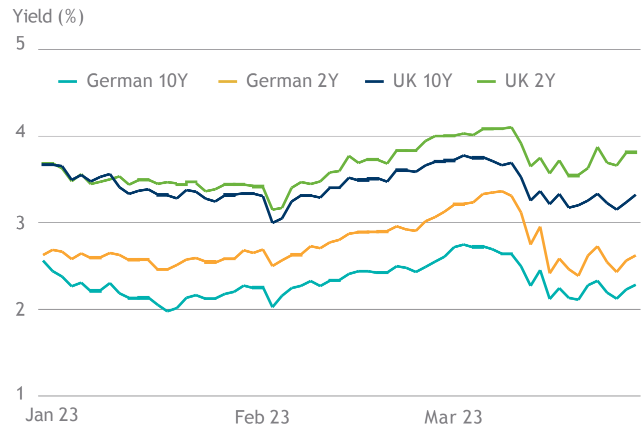
While valuations have started to normalise and the more expensive end of the market has begun to de-rate, the valuation gap between expensive and cheap stocks remains high by historical standards. This creates fertile ground for stock pickers. Therefore, we believe our focus on valuations, along with financial volatility, should bring benefits as the year unfolds.

European Fixed Income

High inflation and central bank policies mainly drove fixed income markets until mid-March. The focus then shifted dramatically after the failure of US regional banks SVB and Signature Bank and Credit Suisse's stunning sale to UBS.

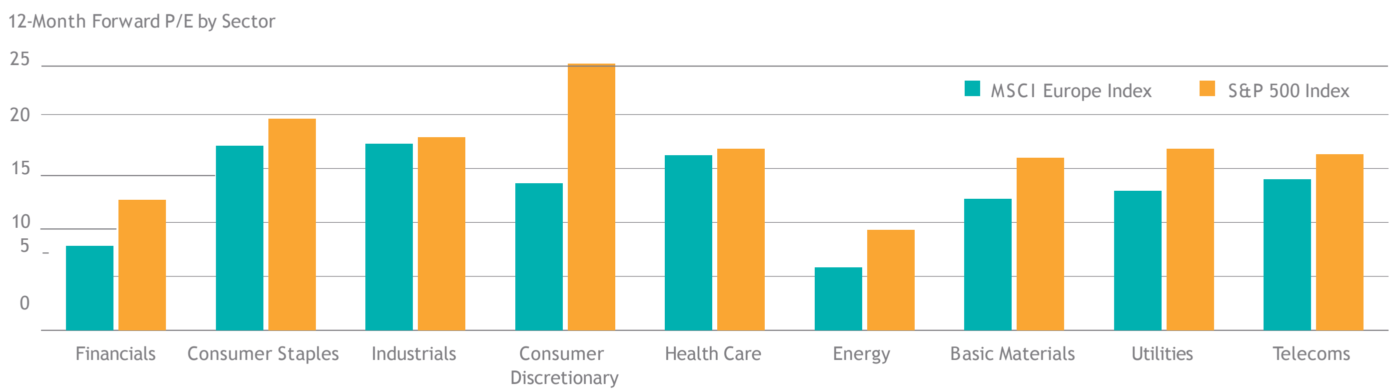
These remarkable events stoked fears of a systemic banking sector crisis amidst concerns over a potential domino effect. In turn, investors turned to low-risk assets such as German bunds, pushing government yields lower (Exhibit 4). As a result, European government bonds rallied strongly over the quarter (Exhibit 5).

Exhibit 4
Euro Zone and UK Government Bond Yield Movements in Q1 2023



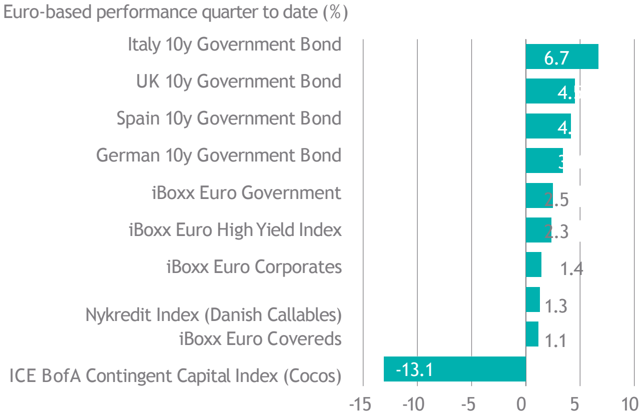
As at 28 March 2023 Source: Refinitiv Datastream

Exhibit 3
Europe vs. US Sector Valuation Comparison



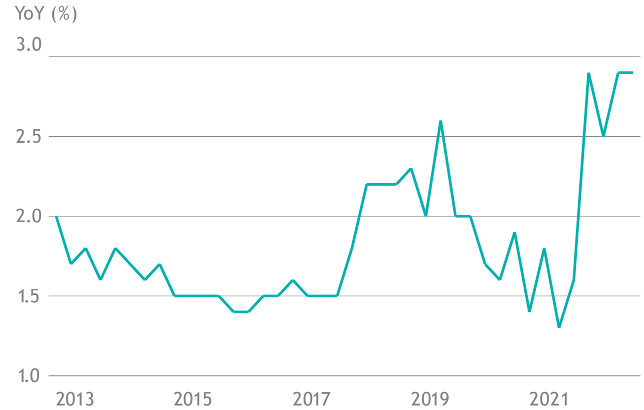
As at 23 March 2023
Source: FactSet

Exhibit 5
Flight to Safety—European Fixed Income Surged in Q1 2023



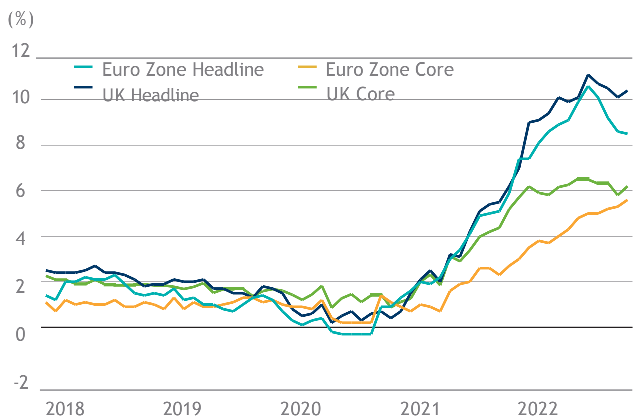
As at 31 March 2023 Source:
Refinitiv Datastream

Exhibit 7
Wage Claims Climbing: Euro Zone—Indicator of Negotiated Wages



As at 31 December 2022
Source: Refinitiv Datastream

Exhibit 6
Core Inflation Concerns—Headline and Core Euro Zone and UK Inflation



As at 28 February 2023 Source:
Refinitiv Datastream

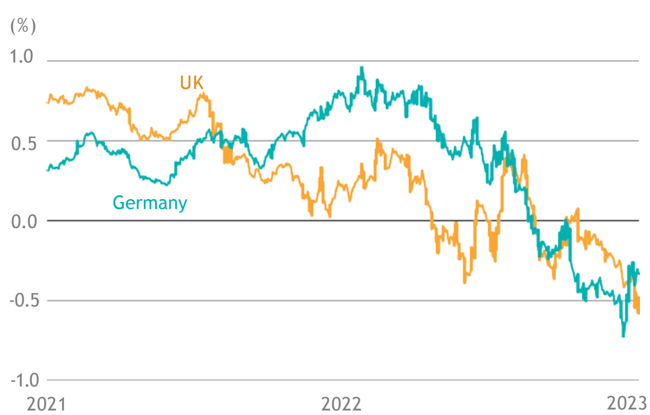
Despite the tremors in the banking sector, sticky inflation and a surprisingly resilient labour market continue to call for a restrictive monetary policy. While falling energy prices have caused headline inflation to drop, core inflation remains stubbornly high and is even increasing. This could become a problem in the months ahead (Exhibit 6). Wage increases are exerting increasing pressure on broad euro zone inflation as workers demand higher compensation to counter real income losses (Exhibit 7).

Faced with still-elevated inflation and wage claim pressures, Europe's central banks raised interest rates in March despite the turmoil in the banking sector, effectively sending a signal that there was no sign of a looming systemic banking crisis in Europe. The ECB hiked its key interest rates by 0.50% while the Bank of England and Norges Bank, the Norwegian central bank, each increased their main interest rates by 0.25%.

Due to stubbornly high inflation, we do not expect a premature end to the current rate-hiking cycle. However, the bulk of interest-rate increases have already been implemented, and the potential for further substantial rises is becoming ever more limited. Price pressures should ease somewhat as the year progresses, thus central banks should reach their respective terminal interest rates.

The risk of a recession in Europe, implied by an inverted yield curve (Exhibit 8), remains, even if economic data has held up better than expected. The individual euro zone countries and the UK are either already in a stagnation/recession environment or are expected to slide into one in the coming months. Nevertheless, the reopening of the Chinese economy and the absence of an energy crisis in Europe have to an extent improved the outlook for global growth in 2023.

Exhibit 8
Inverted Yield Curves Point to a European and UK Recession



As at 31 March 2023
Shows yield differential between 10-year bonds and 2-year bonds.
Source: Refinitiv Datastream

The global battle against inflation by central banks not only represents a recession risk but poses a non-trivial risk to the stability of the global financial system. The first signs were seen last autumn with the liability-driven investment (LDI) crisis in the UK, followed by the March failures of SVB and Signature Bank and, a week later, Credit Suisse's rescue by UBS.

More positively, fears of a European banking crisis should soon subside now that a catastrophic failure of Credit Suisse has been averted.
Provided banks have sufficient liquidity—and they have been helped by the ECB's support—there is limited default risk within the European banking sector.

But recent turbulence has shown that rate hikes are painful. Tightening cycles create headwinds for financial asset values. Nonetheless, Credit Suisse aside, the large European banks are in good shape, with robust capital levels and high liquidity ratios. Moreover, policymakers will quickly step in with measures to stop any contagion that might lead to a severe banking crisis. Therefore, we do not expect a systemic banking crisis in the weeks and months to come. Once the market realises the limited contagion risk within the European banking sector, the focus will again shift to inflation and central bank policy.

What does this mean for fixed income investments? In our view, rate volatility will stay elevated for some time to come. Today's higher yields look attractive, with further rate hikes already priced in (thus reflected in current yields). However, we believe investors should adopt a cautious stance in view of the current high levels of uncertainty.

We currently prefer investment grade over high yield bonds, especially in the corporate segment where stricter financing conditions could cause problems for some high yield issuers. We do see one exception here: the Nordic high yield market. It offers attractive yields, a modest duration of below one year, and diversification benefits. Overall, we believe 2023 should be a positive year for European fixed income marked by some attractive opportunities.

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Published on 8 May 2023.

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